 ORIGINAL

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of 1993 Annual Access Tariff Filings	CC Docket No. 93-193

TO THE COMMISSION

DIRECT CASE OF SOUTHWESTERN BELL TELEPHONE COMPANY

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DIRECT CASE OF
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SUMMARY*

This Direct Case responds to the questions posed to SWBT and other LECs by the MO&O. Specifically, SWBT shows herein that

Even assuming for the sake of argument that the level of inquiry

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OF SOUTHWESTERN BELL TELEPHONE COMPANY

Pursuant to the MO&O in the above-referenced docket,[1] Southwestern Bell Telephone Company (SWBT) hereby files its Direct Case. This Direct Case shows that SWBT has borne its burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the Transition Benefit Obligation (TBO) amounts, that SWBT has properly reallocated General Support Facility (GSF) costs, and that SWBT has properly placed Line Information Database (LIDB) query charges in the Transport category.

I. SWBT HAS BORNE ITS BURDEN OF DEMONSTRATING THAT IMPLEMENTING SFAS-106 RESULTS IN AN EXOGENOUS COST CHANGE FOR THE TBO AMOUNTS UNDER THE COMMISSION'S PRICE CAP RULES.

Regarding exogenous treatment of the incremental interstate costs recognized under SFAS-106 accounting, the MO&O raises the following issue for further investigation:

Have the local exchange carriers (LECs) borne their burden of demonstrating that implementing SFAS-106 results in an exogenous cost change for the Transition Benefit Obligation (TBO) amounts under the Commission's price cap rules?

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[1] 1993 Annual Access Tariff Filings, CC Docket 93-193, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation (DA-93-762) (released June 23, 1993) (MO&O).

Under this broad issue, the MO&O claims that the record is inconclusive concerning "control" and that there are other aspects of "double counting" that have not been sufficiently addressed. These "double counting" subjects are:[2]

> the [potential] intertemporal double counting issue;[3]
>
> [the potential] double counting related to the inclusion of costs in the prescription of the rate of return which determined the initial price cap rates;[4]
>
> and the [potential] anticipation of SFAS-106 costs in the studies underlying the productivity factors.[5]

The MO&O also directed the LECs to provide specific data as follows:

> We direct the LECs to provide evidence of and describe the ranges of data on the age of the workforce, the ages at which employees will retire, and the length of service of retirees, presented by their actuaries and used by the companies to compute Other Postretirement Employee's Benefits (OPEB) amounts claimed in the annual access transmittals.[6]
>
> We direct the LECs to provide pertinent sections of their employee handbooks, contracts with unions, and other items that include statements to the employees concerning the company's ability to modify its post-employment benefits package.[7]

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[2] Id. at para. 28.

[3] Id. at para. 29.

[4] Id.

[5] Id.

[6] Id. at para. 105, Item 1.

[7] Id.

SWBT will address each of these issues herein.

A. BACKGROUND

At this point, the formal record regarding exogenous treatment for OPEBs is lengthy. Thus, it is helpful to begin this Direct Case by summarizing several key Commission decisions that establish the precedent for exogenous treatment of the incremental cost recognized under SFAS-106 accounting.

In 1989, the Commission explicitly recognized the need to allow rate recovery for extraordinary cost changes imposed by Generally Accepted Accounting Principles (GAAP) changes.[8] The Commission adopted rules in the AT&T price cap plan that assured AT&T exogenous treatment of GAAP changes.[9] Because the Commission has been consistent in its application of exogenous treatment to price cap carriers regardless of whether they were interexchange or local exchange carriers, price cap LECs believed they were assured of exogenous treatment of GAAP changes.

In 1990, LECs were notified by the Commission that carriers would be allowed to reflect GAAP changes in their price caps after the GAAP changes were approved.[10] These orders,

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[8] Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873 (1989) (Report and Order and Second Further Notice) at para. 654.

[9] Id. at para. 295 and 47 C.F.R. Section 61.44(c)(2).

[10] Policy and Rules Concerning Rates for Dominant Carriers, 5

explicitly assured all interested parties that Commission-approved

carriers subject to price cap regulation as well as those subject to rate of return (ROR) regulation.[13]

Without explicit Part 32 rules changes for SFAS-106, on May 4, 1992, the Commission released accounting guidelines specifying which Part 32 accounts should be used to record postretirement benefits recognized under SFAS-106 accounting.[14] The effect of the 1992 release of new accounting guidelines was to modify or reinterpret the Commission's Part 32 Accounting Rules and Part 65 Rules regarding ratebase treatment.

Thus, in 1991 and 1992, the Commission explicitly ruled that SFAS-106 accounting was compatible with the Commission's regulatory accounting needs. By these actions, the Commission concurred with the FASB and concluded that the SFAS-106 method of accounting represented a true and accurate method of recording OPEB costs. The SFAS-106 Adoption Order established SFAS-106-recorded OPEB costs as real costs. SFAS-106 costs, as defined by the Commission's accounting orders and guidelines, thereby fit the Commission's definition of exogenous costs as being "triggered by administrative, legislative or judicial action beyond the control of carriers."[15]

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[13] Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, 50 F.R. 48408, November 25, 1985.

[14] Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32, RAO Letter 20, released May 4, 1992. RAO Letter 20 provides the guidance for rules changes to Part 32 and defines the transition obligation as "the carrier's unfunded liability for benefits earned in the past as of the date SFAS-106 is implemented."

[15] LEC Price Cap Order, at para. 166.

In April of 1991, however, the Commission modified its standard for exogenous treatment of accounting changes, establishing a two-pronged test.[16] The Commission explicitly stated that:

> The test of whether to grant exogenous treatment of GAAP changes is not restricted to whether the change is outside the control of the carrier.[17]

The Commission additionally required that:

> The determination of whether a particular GAAP change is exogenous included an analysis of whether the cost change will be reflected in the inflation variable of the Price Cap Index (PCI).[18]

Thus, the Commission required a two-pronged showing for GAAP changes to be treated as exogenous: (1) the accounting change was beyond the control of the LEC; and (2) the change was not double counted in the Gross National Product-Price Index (GNP-PI) inflation measure used in the price cap index formula. This change in the standard for determining whether an accounting change would qualify for exogenous treatment was imposed on the price cap LECs well after the Commission made its price cap form of regulation mandatory for eight LECs, including SWBT.[19] This change also became mandatory for "optional" price cap LECs because of the

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[16] LEC Price Cap Order on Reconsideration, at para. 63.

[17] Id.

[18] Id.

[19] LEC Price Cap Order, at para. 262.

provision in the LEC price cap plan that electing price cap regulation is an irrevocable decision.[20]

Subsequent orders relating to exogenous treatment issues have described this test in different ways, but 47 C.F.R. Section 61.45 (d), the section that supposedly defines this two-pronged test, has not been altered since expansion of the test to a two-pronged test in April of 1991.

On June 1, 1992, SWBT filed its Direct Case in CC Docket No. 92-101, requesting exogenous treatment under the two-prong standard for exogenous treatment for accounting changes established by the Commission in April of 1991.[21]

On January 22, 1993, the Commission concluded that the price cap LECs had not met their burden of demonstrating that implementation of SFAS-106 should be considered an exogenous cost change under the Commission's price cap rules, but did "not foreclose these carriers or others from making a more persuasive showing in the context of the 1993 annual access tariff filings."[22] The Commission specifically stated that its January Order:

> Is not intended to foreclose further consideration of exogenous treatment of TBO amounts, based on a better and more complete

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[20] Id. at para. 269. ("A LEC electing price cap regulation shall not have the option to return to rate of return regulation.")

[21] SWBT Direct Case, CC Docket No. 92-101, filed June 1, 1992.

[22] Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other than Pensions," 8 FCC Rcd. 1024 (1993). (January Order), at para. 1.

record, for example in the annual 1993 access tariff filings.[23]

In its 1993 Annual Access Tariff Filing, SWBT requested exogenous treatment for only a portion of the increased costs recognized due to the implementation of SFAS-106.[24] This amount is the interstate portion of the amortization of the TBO plus the portion of Interest Cost that relates to the TBO reduced by the Return on Plan Assets.[25]

B. SWBT Has Already Met Its Burden Of Proof.

The MO&O fails to conclude that SWBT has met its burden of proof for exogenous treatment of the incremental interstate costs recognized under mandatory SFAS-106 accounting. Such a reading of the record is not warranted by the facts on the record -- SWBT has already adequately met its burden of proof. The MO&O, however, continues to attempt to increase the burden of proof required of the price cap LECs to demonstrate the appropriateness of exogenous treatment of the incremental costs recognized under the GAAP change for SFAS-106 accounting.

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[23] Id. at para. 76.

[24] SWBT will experience approximately $49M in incremental interstate costs as a result of recognizing OPEB costs on a SFAS-106 basis. SWBT has requested exogenous treatment for only the TBO here, which is only $32.6M of those increased costs. This fact should be taken into account to indicate that SWBT's current tariff request is conservative.

[25] See, SWBT D&J at p. 3-1. The Bureau, in footnote 27 of the MO&O characterizes SWBT's filing as requesting exogenous treatment for the incremental costs associated with the implementation of SFAS-106 for existing retired employees.

SWBT's tariff filing satisfied the current requirements in the Commission's rules that govern the lawful determination of exogenous treatment. SWBT is already pursuing an appeal of the Commission's January Order, which has also attempted to increase the burden of proof required of the price cap LECs.[26]

1. The Change to SFAS-106 Accounting Was Not Within SWBT's Control.

The Commission has already agreed that "the change to accrual accounting by FASB was not within the carrier's control."[27] Thus, with respect to the first prong of the Commission's two-prong test, no further inquiry should be necessary. The January Order, however, states that:

> Parties put forth an overly narrow view of the meaning of control for purposes of evaluating whether a particular cost change warrants exogenous treatment under our price cap plan.[28]

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[26] SWBT has joined with BellSouth Corporation, Bell Atlantic Telephone Companies, New York Telephone Company, New England Telephone and Telegraph Company, GTE Service Corporation, Rochester Telephone Corporation, and The Southern New England Telephone Company in a Joint Petition for Review filed on February 19, 1993 with the United States Court of Appeals for the District of Columbia Circuit. Separate petitions for review were filed by Pacific Bell and US West. By submitting its tariff requesting exogenous treatment for the TBO portion of the costs recognized with the SFAS 106 adoption, SWBT in no way relinquished its right to request full rate recovery of the additional interstate costs recognized under SFAS 106, pending the outcome of the appeal with

This presumption apparently carries over to the MO&O, where the Bureau characterizes this issue as unresolved.

Even though the Commission's rules on exogenous treatment do not require further proof, the Bureau's broader concerns regarding "control" will be addressed by SWBT in this filing. The external regulatory, accounting and practical circumstances leading up to SWBT's request for exogenous treatment, and its commitment to current and retired employees, would make any denial of SWBT's request based on "control" issue grounds, arbitrary and capricious.

SWBT's lack of control is manifested in many ways. SWBT did not control the mandated implementation of SFAS-106 accounting for OPEBs. It did not control the fact that SFAS-106 has specific requirements for determining cost of service for a given level of OPEBs. SWBT does not solely control the results of the collective-bargaining process that determines OPEBs. SWBT did not control the

a. The Focus On The Right To Modify The OPEB Plans Is Misplaced.

By the questions raised in paragraph 105 of the MO&O, resolution of the Bureau's issue of control appears to hinge on whether the price cap LECs retain the ability to modify OPEB plans.[29] A narrow focus on whether a carrier happens to retain a specific legal right to modify OPEB plans should not be dispositive of the broader issue of whether rate recovery of the increased costs recognized under SFAS-106 accounting is warranted. The Commission, like the FASB, should look past the legal issue to the practical effects of OPEB obligations.

b. The FASB Concluded That a Focus On The Right To Modify The OPEB Plans Is Too Narrow.

The FASB has already considered the "control" issue raised by the Bureau, concluding that there is a significant cost to the company from attempting to lower OPEBs. The following are quotes and summaries from the FASB's Statement:

> The Board has looked **beyond the legal status** of the promise to consider whether the liability is effectively binding on the employer because of past practices, social or moral obligations, or customs.[30]
>
> An enterprise is considered to be obligated for these benefits unless it can avoid the future sacrifice at its discretion without significant penalty. The penalty to the employer need not be in the form of a reduction in the value of assets.

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[29] See also, AT&T Opposition, CC Docket No. 92-101, filed July 1, 1992, at pp. 6-9.

[30] SFAS-106, at para. 156 (emphasis added).

> It could refuse to pay only by risking substantial employee-relations problems. **As a practical matter, it is unlikely that an employer could terminate its existing obligation under a postretirement benefit plan without incurring some cost.** Therefore, the Board concluded that in the absence of evidence to the contrary, an employer is presumed to have accepted responsibility to provide the promised benefits. Consequently, the accounting ... is based on the **presumption that the plan will continue and that the benefits promised by the employer will be provided.**[31]

This determination by the FASB was made with the knowledge that some companies retain the legal right to modify or terminate OPEB plans. The Commission must also look beyond the legal status of the OPEB plans, to the practical commitment represented by the price cap LECs' relationships with their employees and retirees.

The Commission has already stated that it does not intend its actions in this proceeding to encourage carriers to reduce or eliminate medical benefits to employees and retirees.[32]

c. The SWBT/CWA Contract Affects SWBT's Ability to Modify Medical Benefits.

The MO&O directs the LECs subject to the investigation:

> to provide pertinent sections of their employee handbooks, contracts with unions, and other items that include statements to the employees concerning the company's ability to modify its post-employment benefits package.[33]

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[31] SFAS-106, at para. 157 (emphasis added).

[32] January Order, at para. 41.

[33] MO&O, at para. 105, item 1.

Relevant sections of the settlement agreement between SWBT and the Communications Workers of America (CWA) are attached as Appendix A.

[redacted]

its employees and retirees places practical constraints on SWBT's flexibility. SWBT cannot alter the provisions of the medical plan that apply to active employees while the existing contract is in place unless the CWA agrees to the modification. Only through collective bargaining with the CWA can SWBT reach any agreement on changes to the contract, including the benefit agreements.

Practically speaking, any company proposal to reduce future retiree medical benefits would be strongly objected to by the CWA and employees. Medical plan changes have been an important component of past contract negotiations.[36] Furthermore, the CWA has strongly expressed the importance to its members of the continuance of medical care plans.[37]

The Commission apparently significantly overestimates the ease with which SWBT could eliminate benefits. SWBT takes its responsibility for the welfare of its employees and retirees very seriously. To that extent, SWBT currently intends to continue to offer a fair total compensation package, which includes OPEBs, and which balances the needs of customers, employees, retirees, and shareholders.

SWBT cannot unilaterally alter its benefits for any of its collectively-bargained-for employees, approximately 75% of all SWBT employees. SWBT would face significant penalties (for

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[36] Note the four-month strike against NYNEX largely attributable to medical benefit issues in 1990.

[37] See Letter from Victor C. Crawley, Vice President, District 6, Communication Workers of America, to chairman James Quello, June 18, 1993, attached here as Appendix F. Identical letters were sent to Commissioner Barrett and Commissioner Duggan on the same date.

example, strike actions by the CWA and/or numerous lawsuits by current retirees/employees) in the event that it ever tried to significantly alter or terminate the OPEB benefits reflected in the TBO.

Investment analysts have recognized the importance of union contracts. The following quote is taken from a Goldman Sachs report:

> In general, many large economy-sensitive firms have unionized work forces and low rates of employee turnover. The presence of union contracts prevents these corporations from minimizing or eliminating the adverse impact of the FAS 106 ruling by changing or canceling their postretirement benefit programs.[38]

Moreover, any modifications of OPEB plans, should they take place, would likely affect only current employees and therefore have little relevance when considering exogenous treatment of the TBO.

d. SWBT Has Already Instituted Significant Efficiencies in the Management of its Health Care Plans.

The January Order appeared to imply that the control prong of the Commission's two-pronged test would be satisfied based on whether or how carriers can affect changes in the cost of OPEB claims.[39] Importantly, SWBT's exogenous amount is not based on the projected amount of OPEB claims, but on amounts much less than expected claims. Thus, reductions in the expected OPEB claims

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[38] FAS 106: Facing the Future, Strategy Brief, Goldman Sachs, June 1, 1992.

[39] January Order, at para. 54.

amounts over very wide ranges will not reduce SWBT's estimate of SFAS-106-determined TBO amounts on behalf of future retirees.

The Commission's January Order concludes that carriers' OPEB costs represent an area ripe for future efficiency gains.[40] The Commission's expectations for aggressive management of health care costs, however, have already been fulfilled in SWBT's case by the bold and innovative actions that SWBT has taken over the past seven years. SWBT has been in the forefront of managed health care and aggressive cost containment. SWBT's Transmittal No. 2271 and its prior filings in 1992 have demonstrated this point in further detail.[41]

Thus, SWBT has been extremely aggressive in its management of health care costs. Because of this aggressive management, SWBT's valuation of the TBO already contains a highly significant curtailment of health care inflation rates. It is from this lower base of current health care costs that SWBT must now attempt to recover the future increased accounting costs caused by the mandatory implementation of SFAS-106.

e. SWBT'S Actuarial Valuation is Very Conservative.

In addition to SWBT's aggressive management of health costs, SWBT's SFAS-106 valuation that served as the basis for both

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[40] Id.

[41] SWBT Tariff Transmittal No. 2271, Description and Justification, pp. 3-15 - 3-17. See also, SWBT Direct Case, CC Docket No. 92-101, filed June 1, 1992, (1992 Direct Case) Exhibit 2, "Southwestern Bell's Experience with CustomCare: An example of Medical Cost Containment."

its 1992 Direct Case[42] and its 1993 Annual Tariff Filing[43] includes the effects of a benefit cap that significantly reduces the SWBT exogenous amounts. The Commission recognized that benefit caps can significantly reduce estimated OPEB accruals and the resulting exogenous amounts for SFAS-106.[44] For active employees, SWBT's actuarial valuation of the TBO[45] assumes a defined dollar benefit cap on health care benefits which is very conservative and which results in a much lower TBO than would be the case if no benefit cap were assumed. SWBT's use of a flat dollar cap (which results in a 0% medical inflation trend rate once the cap is reached in 1995) assumes that the full brunt of medical care inflation after 1995 will fall on the employee/retiree rather than on SWBT. The effect of the 0% cap is to presume that SWBT's future retirees will pay for 50% of their estimated health care cost by the year 2006. This effect is assumed to continue to grow, so that each year after 2006, future retirees are assumed to pay an increasing share, above 50%.

Thus, even if SWBT were able to achieve significant future health cost containment, it would not further reduce the

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[42] 1992 Direct Case, at p. 29; and SWBT Rebuttal, filed July 31, 1992, at pp. 25, 41.

[43] The dollar-defined benefit cap is described in SWBT Tariff Transmittal No. 2271, Description & Justification (D&J), Volume 1, Section, 3.G, at pp. 3-17 - 3-18.

[44] January Order, at para. 54.

[45] The TBO is SWBT's obligation to current and future retirees for OPEB benefits that have already been "earned" as of the January 1, 1993 implementation date of SFAS-106 for SWBT, under the terms of its current benefits package. SFAS-106 requires that SWBT use the actuarial valuation of its substantive plan provisions.

TBO. Therefore, SWBT's estimate of the exogenous amount for the TBO-only portion is very conservative, because it imposes a 0% medical care inflation rate assumption.

Since a 0% health care inflation rate was used, SWBT cannot be found to have control over the much smaller level of costs that are incorporated in its TBO estimate. Given the very conservative nature of SWBT's actuarial valuation of the TBO, together with the other conservative aspects of SWBT's approach, concerns regarding SWBT's control over the level of cost contained in the TBO are not warranted.

f. SWBT Does Not Relinquish Its Right to Exogenous Treatment of the Ongoing Portion of SFAS-106 Costs.

The January Order, at paragraph 56, finds that "at least as to future accrued OPEB expenses, LECs have substantial control over the amount booked as OPEBs." That finding is on appeal before the U.S. Court of Appeals and SWBT will not address it here.[46]

g. The Commission Has Recognized That SWBT May Have Made Prior Business Decisions Based on Assurances Provided by the Commission.

In discussing the "control" issue as it relates to the TBO portion, the January Order states:

> It appears that LECs may well have less control over some of the amounts included in the TBO because these obligations are based on past contractual obligations, obligations that arose prior to the mandated GAAP change. It is also possible that LECs relied on the initial price cap orders, which indicated that

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[46] See fn. 26 supra. SWBT's 1993 Annual Access Tariff Filing did not request exogenous treatment of the ongoing SFAS-106 expense.

> all mandatory GAAP changes would be considered exogenous, when making business decisions on whether to fund OPEBs. The Commission modified this approach on reconsideration.[47]

Thus, the Commission recognizes that SWBT may have made business decisions based on the assurances contained in prior Commission orders. Certainly, SWBT may have made different business decisions if the Commission had not given these assurances, and it would be arbitrary and capricious for the Commission to now penalize SWBT for decisions which were rational under the business conditions present at the time the decisions were made.

h. SWBT'S Prior Funding Decisions Were Made Based on Commission Assurances of Eventual Rate Recovery For Accrual Accounting For OPEBs.

Before entering price cap regulation, SWBT made decisions regarding the relative attractiveness of funding OPEB obligations based on the expectation that GAAP changes would be afforded exogenous treatment. SWBT made its decision not to prefund Voluntary Employees' Beneficiaries Associations (VEBAs) for payment of OPEB claims based on the explicit assurances contained in the Commission's orders and notices.

SWBT did not and could not have anticipated that the Commission would increase the burden of proof for exogenous treatment of SFAS-106 in such a way that prefunding (which at the time was uneconomical for SWBT)[48] would now appear to have been the

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[47] January Order, at para. 57 and fn. 106.

[48] With perfect hindsight of the subsequent changes in Commission policy on exogenous treatment, prefunding of OPEB obligation would have been an important opportunity for SWBT to (continued...)